United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

No. 75-7648

United States Court of Appeals

FOR THE SECOND CIRCUIT

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P/S

In the Matter Of
WEIS SECURITIES, INC., *Debtor.*

STOCK CLEARING CORPORATION, INC., *Plaintiff-Appellant,*

- against -

EDWARD S. REDINGTON, as Trustee of Weis Securities, Inc.,
Defendant-Appellee,
SECURITIES INVESTOR PROTECTION CORPORATION,
Applicant-Appellee.

Appeal From the United States District Court
for the Southern District of New York

UNITED STATES COURT OF APPEALS
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BRIEF OF APPELLEE SECURITIES INVESTOR PROTECTION CORPORATION

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BRIEF OF APPELLEE SECURITIES INVESTOR PROTECTION CORPORATION

PRELIMINARY STATEMENT

Stock Clearing Corporation ("SCC") has appealed from an order of the United States District Court for the Southern District of New York (Hon. Inzer B. Wyatt) entered October 28, 1975 which affirmed an order of the Bankruptcy Judge (Hon. Roy Babitt) dismissing SCC's complaint for reclamation of stock it delivered to Weis Se-

curities, Inc. ("Weis"). Weis is the debtor in this liquidation proceeding under the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa *et seq.* ("SIPA"). The case was before both courts upon a stipulated record. The Bankruptcy Judge dismissed the complaint on the ground that SCC had neither title to, nor right to possession of, the securities sufficient to form the basis for reclamation. The District Court adopted the Bankruptcy Judge's rationale and affirmed on the further ground that even if SCC had title it parted with such title on the credit of Weis.[1]

COUNTERSTATEMENT OF QUESTION PRESENTED

Is SCC Entitled To Reclamation of Stock and Other Items Where SCC, With Full Knowledge of Weis' Moribund Financial Condition, Failed To Exercise Its Rights to a Possessory Lien and Immediate Payment and Voluntarily Completed Delivery to Weis Which Was Free to Transfer or Otherwise Alienate the Stock?

COUNTERSTATEMENT OF THE CASE

On May 20, 1974 SCC filed its petition to reclaim securities and other items valued at $1,135,459.87.[2] The matter was submitted to the Bankruptcy Judge upon an agreed record.[3] A stipulation (the "Stipulation") was en-

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[1] Neither opinion is reported. However, each will be reproduced in full in the Joint Appendix which has been deferred for filing in this appeal pursuant to Rule 30(c), F.R.C.P.

[2] A stipulation was entered July 3, 1973, pursuant to which the securities have been sold and a fund of $1,135,459.87 has been placed in escrow pending the outcome of this litigation. This fund represents several items, including transfer taxes, clearance cash adjustments, and marks to market, which are not securities. The transfer taxes and clearance cash adjustments are after added items. Stipulation ¶¶ 12, 13.

[3] A comprehensive statement of the facts of this case is set forth in the brief filed by the Trustee. Accordingly, in order to minimize the burden on this Court, SIPC adopts the Trustee's statement as its own.

tered concerning the basic facts which governed transactions between Weis and SCC (Stipulation ¶ 3, Exh. A), the By-Laws (Stipulation ¶ 4, Exh. B) and Rules of SCC (Stipulation ¶ 5, Exh. C), an accounting for the securities delivered to Weis through SCC's facilities on May 24, 1973 (Stipulation ¶¶ 8-13, Exh. D), a classification of the delivered securities (Stipulation ¶ 11, Exh. E), and 200 pages of deposition testimony relating to clearance and settlement procedures and participation in the events of May 24, 1973. It was stipulated that the Clearing Agreement, the By-Laws and the Rules, referred to as the "Applicable Rules" (Stipulation ¶ 6), governed the subject transactions (Stipulation ¶ 7).[4]

Following a careful exposition of the facts the Bankruptcy Judge ruled, on the merits, that a claim for reclamation could only succeed if SCC proved it had title to or a right to possess the securities and other items which was superior to that of the Trustee. This the court found it had not done on the facts advanced. The court specifically considered and rejected the substantive arguments of SCC that its right to assert a lien on the property or its alleged status as a bailee were sufficient to establish a claim for reclamation.

The District Court affirmed the Bankruptcy Judge's reasoning and went further. After additional review of the stipulated facts regarding the actual nature of the transactions, including the free transfer of securities once they had been taken from the premises of SCC, the District

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[4] In its memorandum before the Bankruptcy Court (at 5) SCC argued that whether the transaction was for cash or credit (a question the Court need not reach in arriving at a determination of the issues) depended upon interpretation of the Rules, By-Laws, testimony and custom and practice in the securities industry. Both SCC's memorandum (at 8, 10) and reply memorandum (at 7, 9) in that Court argued the intent of the parties to the transaction. These arguments were carried forward before the District Court. In this light, the present attempts to claim these issues were not before the lower courts appear specious.

Court concluded that even if SCC had title, it voluntarily parted with title on the credit of Weis.

ARGUMENT

Since Title To The Securities And Other Items Passed Directly To Weis And Hence To The Trustee, And Since SCC With Full Knowledge Of Weis' Financial Condition Failed to Exercise Its Rights To A Possessory Lien And Immediate Payment, SCC Can Have No Right Of Reclamation.

Because this Brief is intended solely as a short supplement to the Trustee's Brief, some preliminary discussion of the errant contents of SCC's Brief seems necessary to a correct perspective upon the whole case.

Bankruptcy Judge's Determination

SCC would dismiss the Bankruptcy Judge's thoughtful opinion as a mere denial of SCC's "standing," rather than a dismissal of SCC's reclamation petition on the merits (SCC Brief at 4, 7, 8). SCC's Brief appears to employ the terms "standing" in the technical sense of *Flast v. Cohen*, 392 U.S. 83, 99 (1968) and, by so doing, mischaracterizes the Bankruptcy Judge's square substantive holding that SCC must fail because it lacked essential substantive prerequisites to reclamation.[5] SCC's repeated references to that determination as one affecting "standing" only, a term never used by the Bankruptcy Judge,[6] ignore the well-

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[5] SCC's usage is evident from statements in its Brief (at 4, 8) that ". . . in contrast to the Bankruptcy Court, the District Court directed its attention to the merits . . . .", and that "The District Court, declining to follow the lead of the Bankruptcy Court, focused on the merits of the parties' dispute—whether the subject transaction was for cash or for credit."

[6] At the conclusion of his opinion the District Judge did say "The Bankruptcy Judge ruled that SCC never acquired any title to the property cleared through it *and therefore* had no standing to claim against the escrow fund . . . ." (at 7) (emphasis added). This reference to standing, especially when considered in light of the earlier portion of the opinion (at 3), was clearly not a technical use of the term.

settled proposition that questions of standing relate only to the right of a particular party to litigate a substantive issue and do not directly involve the merits of that issue.[7] Perhaps more to the point, however characterized, the Bankruptcy Judge's rationale (unrefuted by SCC's Brief) is fatal to its position on this appeal.

District Judge's Determination

Drawing out the foregoing theme, SCC's Brief represents that the District Judge eschewed the rationale of the Bankruptcy Judge. For example, it states (at 2) that the District Judge decided ". . . on grounds different from those relied upon by the Bankruptcy Court. . . ." See also note 5, *supra*. SCC's statements and intimations are an unfortunate mischaracterization of the opinion of the District Judge who specifically adopted the Bankruptcy Judge's rulings as "sound" (at 7) and simply added a further ground for dismissal, *i.e.*, that even if SCC had title to the securities it delivered to Weis, it had no reclamation rights because it relied on the credit of Weis—because this was not a cash transaction.

The So-Called Cash Transaction

SCC's contention that its delivery of securities to Weis was a cash transaction clearly ignores the indisputable circumstances surrounding Weis' demise. It is a well-known and judicially recognized fact that Weis was in serious financial difficulty for a significant period of time before May 24, 1973, the date of the transaction in dispute here. *Rich v. New York Stock Exchange*, 522 F.2d 153 (2d Cir. 1975), *reversing*, 379 F. Supp. 1122 (S.D.N.Y. 1974). As the concurring opinion of Judge Feinberg in the cited case

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[7] Warth v. Seldin, 95 S. Ct. 2197, 2206 (1975); Schlesinger v. Reservists to Stop the War, 418 U.S. 208, 225 n. 15 (1974); Association of Data Processing Service Organizations, Inc. v. Camp, 397 U.S. 150, 153 (1970); Flast v. Cohen, *supra*.

aptly stated, weeks before May 24, 1973 "Weis was already moribund."

SCC is the wholly owned subsidiary of the New York Stock Exchange, the defendant in *Rich, supra*. Under section 6 of the Securities Exchange Act of 1934, 15 U.S.C. § 78f, (see also 17 C.F.R. § 240.6a to 6d) and sections 78eee (a)(1), 78hhh, 78iii and 78lll of SIPA,[7a] it is the Exchange's statutory responsibility to regulate and monitor its members, especially in the area of financial responsibility. See *SIPC v. Barbour*, 421 U.S. 412, 95 S. Ct. 1733, 1736-37 (1975). Under section 78eee(a)(1) the Exchange had a statutory duty to keep SIPC informed of the financial difficulties of Weis as they were discovered and intensified. To that end, the Exchange and other self-regulatory organizations maintain surveillance of their financially troubled members. SIPC 1974 ANNUAL REPORT 8 (1975), SIPC 1973 ANNUAL REPORT 16-17 (1974). SIPC's commencement of this liquidation proceeding took place at 12:42 p.m. on May 24, 1973. There can be no serious question that both the Exchange and the SCC were long before fully aware of Weis' profound financial problems, as noted in *Rich, supra*. That is clearly evidenced upon this record by the fact that its difficulties were discussed at two separate meetings (one at the Exchange) by SCC officials in the morning of May 24, 1973 (Petroski Dep., p. 36; Hoyt Dep., pp. 6, 34).

Notwithstanding the foregoing, SCC made a conscious decision to deliver the securities in question to Weis—a conscious choice not to exercise its right to retain those securities by reason of its possessory lien[8] until payment in cash of the sum owed SCC had been arranged (Petroski Dep., p. 37). In short, not only did SCC have no reasonable expectation of a payment in cash or certified check, but it extended credit to Weis in the most precarious of circumstances, of which it was fully aware. SCC's appreciation of

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[7a] References to SIPA are to Title 15 of the United States Code.

[8] See *infra*, p. 11.

Weis' financial distress hardly first materialized when it learned in the mid-afternoon of May 24 that Weis' bank account was "frozen." Rather, at the very outset of that day it knew,[9] and had known for a long time, that any expectation of cash payment was more hope than conviction. Although SCC may well have had the best of intentions early on May 24th when it decided to deal with Weis ". . . in the normal manner, business manner" (Petroski Dep., p. 37), its worthiness of motive can hardly alter the manifest credit nature of its dealings.

SCC's brief would fault the District Court because it did not feel itself shackled to the naked intent of the parties under SCC's Rule 7, which intent was contractually expressed months or years before the events in question. The criticism seems notably unjustified. See note 4, *supra*. SCC's contention ignores all of the realities as they obtained on and before the day in question. It also ignores the indisputable proposition that parties may contract with an intent to engage only in cash transactions, but may subsequently actually deal in credit. It is the substance of the actual transaction which controls. *National City Bank v. Hotchkiss*, 231 U.S. 50 (1913); *In re Yale Express System, Inc.*, 370 F. 2d 433, 438 (2d Cir. 1966); *In re Butterwick*, 131 F. 371 (M.D. Pa. 1904).

Title Passed to Trustee

The issues here arise in a liquidation proceeding under SIPA which makes applicable the provisions of the Bankruptcy Act, "except as inconsistent with the provisions of this Act." § 78fff(c)(1); *see, e.g., Exchange National Bank of Chicago v. Wyatt*, 517 F. 2d 453, 456 (2d Cir. 1975); *SEC v. Wick*, 360 F. Supp. 312, 315 (N.D. Ill. 1973). Pursuant to section 70a(5) of the Bankruptcy Act [11 U.S.C.

[9] It also knew, by means of the balance orders prepared in its Clearing Department (Rule 5, § 4; Petroski Dep., p. 13), the volume of Weis' trades which were due for settlement on May 24 and was thus in a position to assess with reasonable accuracy the magnitude of the risk it was taking in deciding upon business as usual.

§110a(5)] the trustee is vested, as of the filing of the petition (May 24, 1973), with title of the bankrupt to property which the bankrupt could by any means have transferred or which was alienable by him. *Burlingham v. Crouse*, 228 U.S. 459, 467 (1913); *Klebanoff v. Mutual Life Ins. Co. of N.Y.*, 362 F. 2d 975 (2d Cir. 1966).

The term "title" covers "any interest in the property the bankrupt may have had, however minute, that was subject to transfer by him." 4 COLLIER ON BANKRUPTCY ¶ 70.15 at 143, quoting *Brown v. Crawford*, 252 F. 248 (D. Or. 1918). The trustee's title is not confined to property which is owned absolutely by the bankrupt, but extends to property in which he has a transferable interest. *Segal v. Rochelle*, 382 U.S. 375, 377 (1966). The main thrust of section 70a(5) is to secure for the benefit of creditors everything of value the bankrupt may possess in alienable or leviable form. *Segal v. Rochelle*, *supra* at 379; *Lines v. Frederick*, 400 U.S. 18 (1970).

The extent of the bankrupt's interest in property and whether that interest is transferable is governed by the law of the state. *Klebanoff v. Mutual Life Ins. Co. of N.Y.*, *supra*, 362 F. 2d at 978; *In re Wetteroff*, 453 F. 2d 544, 546 (8th Cir. 1972); *In re Easy Living, Inc.*, 407 F. 2d 142, 144 (6th Cir. 1969). The controlling state law in this instance is the New York Uniform Commercial Code, Article 8, Investment Securities (McKinney 1975). *See, e.g., SEC v. John E. Samuel & Co.*, Fed. Sec. L. Rep. ¶ 93,720 (S.D.N.Y. 1973). UCC section 8-301(1) provides, in part, that "upon delivery of a security the purchaser[10] acquires the rights which his transferor had or had actual authority to convey . . . ." Delivery of securities is defined in UCC section 1-201(14) as a "voluntary transfer of possession." There is no dispute in this case that the transfer was voluntary, nor is there any question that the delivering brokers had

[10] Weis was a "purchaser" of the securities in question. See UCC §§ 1-201 (33) and 1-201(32).

the right to deliver through SCC to Weis. As the District Court found (at 10), there were no restrictions placed on the use of the securities received by Weis and they could be delivered to customers, pledged or sold. See also Petroski Dep., p. 19; Dybo Dep., pp. 59, 60.

The actual time and manner of delivery is governed under the UCC by sections 8-313 [11] and 8-320.[12] Under the

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[11] "Section 8—313. When Delivery to the Purchaser Occurs; Purchaser's Broker as Holder.

(1) Delivery to a purchaser occurs when

(a) he or a person designated by him acquires possession of a security; or

(b) his broker acquires possession of a security specially indorsed to or issued in the name of the purchaser; or

(c) his broker sends him confirmation of the purchase and also by book entry or otherwise identifies a specific security in the broker's possession as belonging to the purchaser; or

(d) with respect to an identified security to be delivered while still in the possession of a third person when that person acknowledges that he holds for the purchaser; or

(e) appropriate entries on the books of a clearing corporation are made under Section 8-320.

(2) The purchaser is the owner of a security held for him by his broker, but is not the holder except as specified in subparagraphs (b), (c) and (e) of subsection (1). Where a security is part of a fungible bulk the purchaser is the owner of a proportionate property interest in the fungible bulk.

* * * * *"

[12] "Section 8—320. Transfer or Pledge within a Central Depository System.

(1) If a security

(a) is in the custody of a clearing corporation or of a custodian bank or a nominee of either subject to the instructions of the clearing corporation; and

(b) is in bearer form or indorsed in blank by an appropriate person or registered in the name of the clearing corporation or custodian bank or a nominee of either; and

(c) is shown on the account of a transferor or pledgor on the books of the clearing corporation;

then, in addition to other methods, a transfer or pledge of the security or any interest therein may be effected by the making of appropriate entries on the books of the clearing corporation reducing the account of the transferor or pledgor and increasing the account of the transferee or pledgee by the amount of the obligation or the number of shares or rights transferred or pledged.

(2) Under this section entries may be with respect to like securities or inter-

relevant portions of UCC section 8-313(1) delivery of the securities, whether for Weis' own account or for the accounts of Weis' customers, occurred both when Weis acquired possession of the securities [UCC section 8-313 (1)] and when, pursuant to UCC section 8-320, the appropriate entries were made on the books of SCC. A transfer under UCC section 8-320 has the effect of delivery within the meaning of UCC section 8-301 and is complete when the entry has been made on the books of the clearing corporation, reducing the account of the transferor and increasing the account of the transferee. This is in accord with SCC Rule 6, § 1(15) that "at the time of . . . stamping the envelope shall be deemed for all purposes to have been delivered to the receiving . . . member . . . ." See District Court opinion at 4.

The stamping of the credit list is the operative act, under the governing law and rules, which transferred the rights to possession and ownership from the deliverors to Weis and Weis' customers. No mention or provision, either in the rules or the UCC, is made for even momentary ownership by the SCC. As the Bankruptcy Judge put it, "SCC was merely a convenient temporary shelter for the securities." (at 12) All of the securities which passed through

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ests therein as a part of a fungible bulk and may refer merely to a quantity of a particular security without reference to the name of the registered owner, certificate or bond number or the like and, in appropriate cases, may be on a net basis taking into account other transfers or pledges of the same security.

(3) A transfer or pledge under this section has the effect of a delivery of a security in bearer form or duly indorsed in blank (Section 8—301) representing the amount of the obligation or the number of shares or rights transferred or pledged. If a pledge or the creation of a security interest is intended, the making of entries has the effect of a taking of delivery by the pledgee or a secured party (Sections 9—304 and 9—305). A transferee or pledgee under this section is a holder.

(4) A transfer or pledge under this section does not constitute a registration of transfer under Part 4 of this Article.

(5) That entries made on the books of the clearing corporation as provided in subsection (1) are not appropriate does not affect the validity or effect of the entries nor the liabilities or obligations of the clearing corporation to any person adversely affected thereby."

SCC to Weis on May 24 were first the property of the delivering brokers and then of Weis for its own or its customers' accounts. There is no dispute that there was delivery to Weis. Therefore, on the filing date these were securities [13] held for Weis or its customers and passed to the Trustee by operation of law.

Rights of SCC Relinquished

Although SCC never owns the items passing through its facilities, it does have a "right . . . to hold property as security for the obligations of . . . members." SCC Rule 6, § 1(6). This "right" is in the nature of a lien [SCC Rules 6, §§ 1(11) and (13)] for any debit balance due SCC. In addition SCC Rule 7 provides that all or any part of a debit balance shall become due on demand.[14]

With knowledge of Weis' precarious financial condition, SCC allowed Weis to pick up securities throughout the day, failed to demand immediate cash payment under SCC Rule

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[13] The record shows (Stipulation ¶ 10, Exh. D, Note 1) only four envelopes which may have been delivered to Weis after the petition was filed. The delivery through SCC is distinguishable from the direct broker to broker clearing in SEC v. John E. Samuel & Co., *supra*. Here, because SCC was a "mere temporary shelter," it never acquired more than the right to retain possession under its lien provisions and consequently lacks the ownership required to sustain reclamation. Once SCC parted with possession it had no right to pursue the property. Furthermore, the items transferred were attributable to Weis' customers, (Stipulation ¶ 11, Exh. E) and reclamation would accordingly be barred by reason of the arguments advanced by the Trustee.

In any event, a portion of these "after delivered" items were 'marks to market' where no securities actually changed hands. On May 24, Weis was credited with $38,000.00 due to such 'marks.' (Stipulation ¶ 11, Exh. E, 5). The remainder of the "after delivered" items involved return of securities attributable to Weis' customers which had been loaned to other brokers. Return of this property to Weis, after bankruptcy but before adjudication was proper under § 70d(2) of the Bankruptcy Act, 11 U.S.C. § 110d(2), and absent exercise of its possessory lien could not benefit SCC.

[14] SCC argues that Rule 7 is the total contract between the parties, though in citing the "pertinent part" of the Rule it neglects to include the demand provision. As indicated above (see n. 4, *supra*) SCC's argument that Rule 7 alone governs is contrary to its argument in the court below and the stipulation of the parties (Stipulation ¶ 7).

7, relinquished its possessory lien, and, finally, having failed to exercise any of the rights available to it, accepted an uncertified check drawn on an account it knew to be frozen (Petroski Dep., pp. 44, 45). This Court is thus presented with a claimant which had available a selection of rights which it deliberately chose not to exercise.[15] Where a claimant relinquishes a lien it is not the policy of the Bankruptcy Act to look with favor upon the claim. *Empire Stevedoring Co. v. Oceanic Adjusters, Ltd.*, 315 F. Supp. 921 (S.D.N.Y. 1970). One who surrenders his lien does so at his own peril, and in case of the debtor's bankruptcy becomes merely another unsecured creditor. *Bower v. Frank*, 219 F. 2d 509 (D.C. Cir. 1955).

In an analogous situation, the day prior to the filing of a petition in bankruptcy a claimant delivered securities to a broker and received from the broker a check for his credit balance. *In re Stanley B. Young & Co., Inc.*, 33 F. Supp. 444 (W.D. Ky. 1940). The claimant, unlike SCC, was without notice regarding the broker's financial affairs. However, like SCC the check he received was dishonored.[16] Upon delivery of the securities to the broker, the claimant parted with title and become a creditor with no lien. Like SCC, the claimant's failure to insist on cash or a certified check before parting with the securities relegated him to the list of general creditors.[17] Of course, *Young* also differs from

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[15] In addition, as explained by SCC's counsel in argument before Bankruptcy Judge Babitt (Transcript, pp. 24, 25), if SCC suffers a loss it has a clearing fund, supported by member assessments, which is "designed to cover" SCC's losses. See also By-Laws, Article VII and Rule 16.

[16] Had the check on the frozen account been honored, the bank would have been liable to the Trustee for the amount disbursed. *See* Bank of Marin v. England, 385 U.S. 99 (1966). Indeed, Bank of Marin suggests that suit could well lie against the payee, even in a situation where the bank, without notice of the bankruptcy, honored the check. To allow otherwise would prove a fraud on creditors for whose benefit the Trustee takes. *See* Moore v. Bay, 284 U.S. 4 (1931); National City Bank v. Hotchkiss, *supra*.

[17] See also Tepper v. Chichester, 285 F. 2d 309 (9th Cir. 1960), a stock broker bankruptcy under section 60e of the Bankruptcy Act in which Tepper's right to reclaim securities was denied because he had no right to immediate possession.

the instant proceeding in that the claimant did at one time have title to the securities.

Can SCC now "be made whole by obtaining property from Weis' Trustee equal in value to Weis' debt to it based on the dishonored check?" Bankruptcy Judge's opinion, at 6. On the facts and law before this Court and the courts below, that question must be answered in the negative.

CONCLUSION

The order of the District Court should be affirmed, with costs to the appellees.

Respectfully submitted,

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BRIEF OF APPELLEE SECURITIES INVESTOR PROTECTION CORPORATION

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